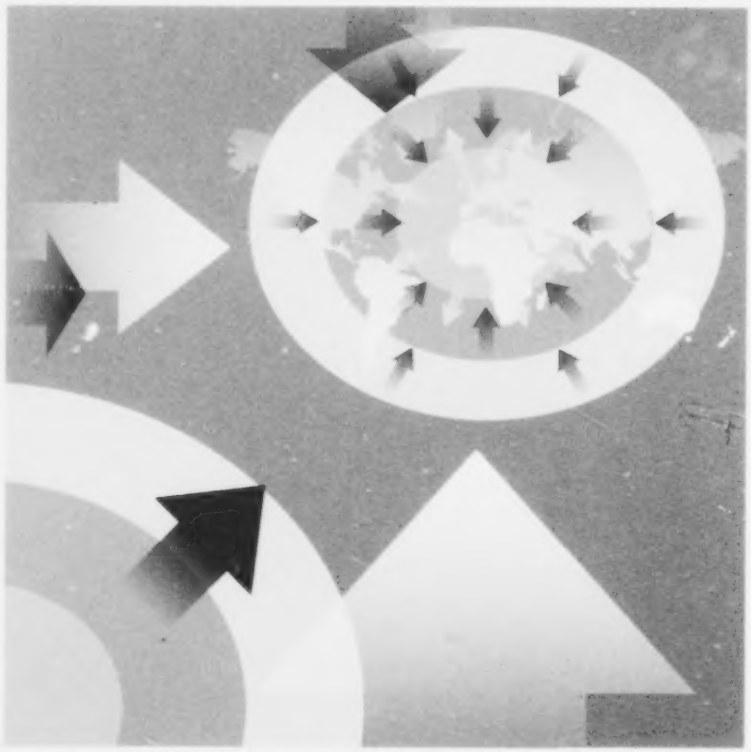
UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

TRADE AND DEVELOPMENT REPORT, 2006

OVERVIEW

UNITED NATIONS

EMBARGO
The contents of this Report must not be quoted or summarized in the print, broadcast or electronic media before
31 August 2006 17:00 hours GMT



UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
Geneva

TRADE AND DEVELOPMENT REPORT, 2006

OVERVIEW

UNITED NATIONS
New York and Geneva, 2006

Note

- Symbols of United Nations documents are composed of capital letters combined with figures. Mention of such a symbol indicates a reference to a United Nations document.

- The designations employed and the presentation of the material in this publication do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area, or of its authorities, or concerning the delimitation of its frontiers or boundaries.

- Material in this publication may be freely quoted or reprinted, but acknowledgement is requested, together with a reference to the document number. A copy of the publication containing the quotation or reprint should be sent to the UNCTAD secretariat.

- The Overview contained herein is also issued as part of the *Trade and Development Report, 2006* (UNCTAD/TDR/2006, sales number E.06.II.D.6).

UNCTAD/TDR/2006 (Overview)

OVERVIEW

Since 2002, world economic expansion has had a strong positive impact on growth and helped support progress towards the United Nations Millennium Development Goals (MDGs). Most developing countries have benefited from this growth momentum as a result of strong demand for their exports of primary commodities and, to an increasing extent, of manufactures. In addition, a number of other changes in the external environment for development over the past 10 to 15 years have benefited individual developing countries in different ways, depending on their economic structure and state of development. These changes include some improvements in market access, provision of debt relief and commitments by donors to substantial increases in ODA, as well as new opportunities to benefit from FDI and increasing migrants' remittances. In order for all developing countries to reach the MDGs and to reduce the large gap in living standards with the more advanced economies, the global partnership for development, stipulated in Goal 8 of the MDGs, needs to be strengthened further. Much depends on the ability of developing countries to adopt more proactive policies in support of capital formation, structural change and technological upgrading, and on the latitude available to them in light of international rules and disciplines.

Strong growth but increasing imbalances in the world economy

The expansion of world output continued unabated in 2005, and is expected to maintain its pace, with a projected GDP growth of 3.6 per cent in 2006. Output growth in developed countries is likely to continue, at 2.5–3 per cent, despite high prices for oil and industrial raw materials and a tendency towards more restrictive monetary policies. So far, turbulence in the financial markets has not adversely affected global growth to any appreciable extent, but the risks of a slowdown are clearly higher than a year ago. Developing countries, including many of the poorest, have benefited from continuing strong demand and rising prices for primary commodities, but for some of them this has also meant a higher import bill for oil and other raw materials. On the other hand, there are serious imbalances in the world economy, which suggests the need for caution in assessing prospects for the coming years, as their correction could have strong repercussions on developing countries.

The developing countries have contributed to the fast pace of global growth, with strong investment dynamics and an overall growth rate averaging about 6 per cent for the group as a whole. In particular, rapid growth in China and India has contributed to this outcome. It is also noteworthy that many African countries have maintained high growth rates. Growth in that region has accelerated every year since 2003, and projections of around 6 per cent growth for sub-Saharan Africa in 2006 signify an exceptional performance.

Strengthened position of emerging-market economies

Recently, there have been signs of increasing volatility in stock, commodity and currency markets, as well as in short-term capital outflows from some emerging markets – some of the ingredients of financial crises in the past. The dollar is highly vulnerable, and international investors appear to have become nervous in the face of continuing global imbalances and rising interest rates. A number of developing countries have experienced a sharp drop in their stock market prices and some emerging-market currencies have fallen markedly against the dollar, the euro, the yen and those currencies closely attached to them. However, the turbulence is limited to some areas and to a number of countries with fairly high current-account deficits. There is little evidence of a looming major financial crisis, comparable to the Asian or Latin American crises some 10 years ago.

Most emerging-market economies are much less vulnerable than at the time of the big shocks that occurred over the past two decades. In 2005, East and South Asian countries recorded a large surplus on their current accounts and Latin America as a whole was also in surplus. After the Asian and Latin American crises more and more developing countries have sought to follow similar paths of adjustment that have involved stabilizing their exchange rates at a rather low level, running sizeable current-account surpluses and accumulating large amounts of dollar reserves. While this practice is widely considered as being suboptimal, in many respects it represents the only feasible way in which developing countries can successfully adapt to the systemic deficiencies afflicting today's global economic order characterized by the absence of symmetric obligations of surplus and deficit countries.

It is no surprise that the undervaluation-*cum*-intervention strategy is especially prevalent among developing countries that have recently experienced currency crises following previous liberalization of their financial systems and capital accounts. Having learned that reliance on foreign savings rarely pays off as a sustainable development strategy, a growing number of developing countries have shifted to an alternative strategy that relies on trade surpluses as the engine for investment and growth. This strategy requires them to defend strategically favourable post-crisis competitiveness positions. But it can only function as long as there is at least one country in the global economy that accepts running the corresponding trade deficit.

Redressing the imbalances

At this juncture, it is mainly because of the flexibility and pragmatism of macroeconomic management by the United States that the systemic deficiencies in the global economic order have not yet led to global deflation, but "only" to these imbalances. There is, however, a risk that the United States may become overburdened in playing the lead role as the global engine for growth for too long. So far, it has been able to neglect its external imbalance as this presented no serious conflict with efforts to sustain full employment and price stability, but there is growing potential for such a conflict. Moreover, there are rising concerns, including among financial market participants, that the imbalance is still growing. It is unlikely that the United States personal savings rate will decline by another 5 percentage points over the next decade, or that the public budget will be allowed to deteriorate by another 6 per cent of GDP. Thus the world economy might soon be without the growth stimuli that have driven it for the past 15 years. There is the prospect of a further dollar depreciation, which would help re-

store competitiveness and rebalance the external accounts. But the effect of a marked slowdown in United States imports would be spread and amplified across the world economy just as the positive impulses were for all these years. This could quite easily halt the momentum in development progress and poverty reduction achieved in developing countries in recent years, for no fault of theirs.

Notwithstanding the large surpluses of a number of developing countries, the main reason for the United States' perhaps increasingly unmanageable global burden is that some other key industrialized countries, rather than assuming a supportive role, have added to the global burden of the United States. Given the huge external surplus of Japan and Germany, and the significant improvements in their competitive positions in recent years, the required competitiveness gains of the United States should now come mainly at their expense, a process that would be greatly facilitated if the stagnant demand that has prevailed in these economies for all too long were to become more buoyant.

China's role in a benign redressing of global imbalances differs from that of Japan and Germany. Since the beginning of the 1990s, China's domestic demand, along with its imports, has grown very strongly, and the country has played a vital role in spreading and sustaining growth momentum throughout the developing world – a process that must not be derailed. Therefore, renminbi revaluation should continue gradually, rather than abruptly, taking due account of the regional ramifications. Similar to China, oil-producing countries have only recently begun to play a significant part in the imbalances. Should the high level of oil prices persist, they could contribute to a benign redressing of global imbalances through stronger domestic demand growth and greater social and physical investment with a view to diversifying their economies.

Crucially, what is needed for redressing global imbalances is a responsible multilateral effort, rather than pressure on parts of

the developing world. A well-coordinated international macroeconomic approach would considerably improve the chances of the poorer countries to consolidate their recent gains in growth performance. In the absence of such an approach, developing countries should defend their strategically advantageous competitive positions and use the favourable overall environment for investing more and reducing their foreign indebtedness.

Failure of the standard reform agenda

The present phase of relatively fast growth in developing countries, driven by strong global demand originating mainly in the United States and amplified by the rapid expansion of the large Chinese economy, comes after two decades of unsatisfactory growth in most developing countries, especially in Africa and Latin America.

During the 1980s and 1990s, most developing countries undertook far-reaching market-oriented reforms with the expectation that improved factor allocation would be key to their integration into a globalizing world economy. The Bretton Woods institutions played a dominant role in this context, both as lenders, imposing their policy conditionality on borrowing countries, and as "think tanks" with a major impact on the international policy debate. As a result, the principles underlying the reform agenda not only shaped the economic policies of countries that borrowed from the international financial institutions; they also came to be widely accepted as the standard reform package for other countries that were reviewing their development strategies for achieving closer integration into the globalizing world economy.

The reform agenda focused almost exclusively on market forces for more efficient resource allocation through improvements in the incentive structure and on reduced discretionary State inter-

vention. Efficiency enhancement in resource allocation was sought through liberalization and deregulation at the national level, and through opening up to competition at the global level. Over the years, the reform agenda has been extended to include additional elements such as capital-account liberalization and improvements in national governance on the one hand, and greater emphasis on poverty reduction and social aspects of development on the other.

The orthodox reform agenda was based on the belief that capital accumulation, a precondition both for output growth and for changes in economic structures, including diversification, industrialization and technological upgrading, would follow automatically from improved allocation of existing resources. This expectation was rarely met. Indeed, the orthodox reforms were frequently accompanied by low rates of investment and deindustrialization, often with negative social consequences. The fast pace of trade liberalization caused trade deficits associated with any given rate of growth to become larger, adding to payments difficulties and increasing dependence on capital inflows. And efforts to attract capital inflows involved raising interest rates – which hindered domestic investment and slowed growth – and currency appreciation, which compromised the international competitiveness of domestic producers and adversely affected trade performance. In most countries of Africa and Latin America, capital accumulation did not keep pace with the increased need for productivity enhancement and technological innovation, which are basic requirements for the success of export-oriented development strategies. Moreover, although liberalization and deregulation may have generated efficiency gains, these gains did not automatically translate into faster income growth. Instead, they often led to growing inequality. Policies promoted with a view to getting relative prices "right" at the micro level failed, because in too many cases they got prices "wrong" at the macro level.

At the same time, a number of East Asian countries succeeded in their catch-up efforts, based on a high level of capital accumula-

tion combined with gradual and often strategic opening up to international markets. However, a dramatic downturn occurred in these countries in the late 1990s, when, distinct from earlier prudent and strategic management of trade liberalization, governments undertook premature capital-account liberalization, which made their economies vulnerable to the vagaries of international capital markets.

The crisis was a turning point in several respects. First, there was mounting criticism of the IMF's diagnoses before and after the crisis and of its policy prescriptions, leading the Fund to soften its stance with regard to capital-account management. Second, not all the countries affected by the crisis accepted the IMF's prescriptions for adjustment, resulting in a sharp decline in demand for IMF assistance as countries sought to avoid the conditionality attached to it. Moreover, some regional initiatives for closer monetary and financial cooperation were launched or strengthened with a view to reducing dependence on the IMF in crisis situations. Third, the belief that integration into international capital markets is generally beneficial because it allows access to foreign savings, and that domestic monetary policies have to be geared to generating confidence in international financial markets, was severely shaken. Experts and international institutions as well as governments began to view managed exchange-rate systems in a more favourable light, and many countries changed their policy objectives in favour of generating trade surpluses and accumulating reserves.

A new focus on poverty reduction

The meagre results of the traditional reform policies led to the growing perception in the course of the 1990s that the standard reform agenda would have to be complemented by measures for strengthening property rights – as the key institutional element for solving the problem of insufficient investment. It was also recognized that additional efforts were needed to mitigate the effects of poverty, in response to a universally perceived humanitarian need, and to make the reforms socially acceptable. Poverty reduction was to be achieved by redirecting public expenditure to address the symptoms of poverty. But such a policy is unlikely to have a lasting impact as long as structural change remains slow and capital accumulation is insufficient to boost growth, increase productive capacity and create employment for the poor. While increased efforts for poverty eradication are a global ethical imperative, it is equally imperative to finance such expenditure out of additional resources; shifting public finances away from investment that can have long-lasting effects on the causes of poverty to social spending that might temporarily cure the symptoms of poverty can be counterproductive in the long run.

The formulation of the MDGs in 2000 reflected the degree of dissatisfaction among global policymakers with progress in development and in the fight against poverty under the conditions that had prevailed over the previous two decades. Goal 8 of the MDGs – Develop a global partnership for development – therefore added an international dimension to the reform agenda. Furthermore, in 2002, the Monterrey Consensus recognized that the capacity of developing countries to realize the MDGs is heavily influenced by external factors, including, *inter alia*, the international macroeco-

nomic and trading environment, aid flows and an international solution to the debt problem. The Consensus also recognized the challenge facing developing countries to create the necessary internal conditions for adequate levels of productive investment and ensure complementarity of public and private investment in the development of local capacities – aspects that were largely neglected in earlier reform programmes. There can be little doubt that an enabling environment for economic development is strongly influenced by the way markets operate, but it is also characterized by externalities of various kinds. Yet policy prescriptions focusing on "getting the prices right" through market liberalization limit the scope for proactive government policies to address such externalities, which in many cases can be decisive for investment decisions.

Improved export opportunities

The external environment for development is determined by the growth performance, cyclical and structural changes as well as economic policy decisions of developed countries. Fast and sustained growth in East and South Asia has added an additional dimension to this interdependence, but global demand conditions, and thus developing countries' export opportunities, continue to be shaped by the major industrialized countries. In addition to expanding global demand, improved market access conditions in developed countries are a key determinant of developing countries' export opportunities. These market access conditions have somewhat improved as a result of multilateral trade liberalization, regional trade agreements and non-reciprocal preferential trading agreements, but, overall, the conditions continue to be biased against developing countries. It is also noteworthy that the reduction in tariff barriers has been accompanied by an increase in the use of non-tariff measures, particularly anti-dumping measures, which have emerged over

the past 25 years as the most widespread impediment to international trade, and to exports from developing countries in particular. Trade preferences often have not been fully utilized and have generated limited benefits, not only because of uncertainty surrounding the schemes, along with restrictive rules of origin and insufficient product coverage, but also because of supply-capacity constraints. High hopes are attached to the ongoing Doha Round of multilateral trade negotiations, but unless its development ambition is fully realized, the Round is unlikely to bring major improvements in the overall export opportunities of developing countries. Estimates of the aggregate gains that can be expected to result from a successful conclusion of the Round in terms of exports and income are relatively modest, and the rise in total developing-country exports will be distributed unequally across countries.

Progress with debt relief and new ODA commitments

Another important factor shaping the external environment of many developing countries, in particular the poorest ones, is official development assistance (ODA) and international support for solving external debt problems. In this regard, the launching of the Heavily Indebted Poor Countries (HIPC) Debt Initiative in 1996 was a landmark. However, after 10 years of implementation, this initiative has not yet succeeded in meeting all its goals. So far, less than half of the eligible countries have benefited from the full amount of debt relief possible under the Initiative, and a number of countries continue to have unsustainable levels of debt, or are expected to again exceed the debt sustainability thresholds in the coming years. Moreover, so far there is no clear evidence that debt relief has been fully additional to ODA flows.

In an additional push to resolve the debt problem of the poorest countries, in July 2005 the G-8 announced the Multilateral Debt Relief Initiative, whereby multilateral financial institutions undertook to cancel the entire debt of countries that have fulfilled the requirements for full bilateral debt relief under the HIPC Initiative. While ample debt relief is a necessary condition for many countries to increase public and private investment, it does not constitute a universal solution to the broader structural problems that led to the accumulation of debt in the first place, and it certainly will not ensure against a recurrence of debt problems.

The challenge of solving these problems has also been recognized by the major ODA donors. Since the beginning of the new millennium many donors have committed to stepping up aid flows to support developing countries in their efforts to reach the MDGs. But even under the most optimistic scenario (i.e. that all donor countries will fully honour their commitments), many developing countries will continue to lack the necessary financial resources for achieving the MDGs. Certainly, most HIPCs will need additional financing in the form of grants, rather than loans, in order to avoid new debt servicing difficulties.

Increasing potential of migrants' remittances and FDI

It is noteworthy that even after a considerable rise in ODA since 2001 and expectations of further increases in the coming years, ODA flows are likely to remain considerably lower than migrants' remittances, which have become an important source of foreign exchange for many developing countries. Remittance inflows to developing countries have been more stable than export earnings and capital flows to these countries, and they are spread more evenly

among developing countries than, for example, FDI flows. The effects on economic growth and long-term development of migrants' remittances, which supplement household incomes, are not very clear, but they are likely to have a direct positive impact on poverty alleviation. As migrants' remittances, which are private income, are expected to grow further for many years to come, consideration might be given to providing incentives for using such inflows for capital formation. This could strengthen their impact on long-term development and at the same time help solve the problems that have been causing emigration in the first place.

After strong and sustained expansion during the 1990s, FDI flows to developing countries have become less stable since the turn of the millennium. While China has emerged as the largest FDI recipient among all developing countries, there has recently been a resurgence of FDI flows to Africa and Latin America, driven by prospects for greater earnings in the extractive industries. The growth of FDI relative to domestic capital formation or GDP suggests that inward FDI has come to play a more significant role in developing economies than it did 20 years ago. But the amount of FDI alone is not an indicator of its contribution to development. Empirical evidence points to considerable variation in the benefits that host countries actually reap from FDI inflows, depending on how FDI policies are integrated into a broader development strategy and on the extent to which private business interests of foreign investors and national development objectives can be reconciled. Weak bargaining and regulatory capabilities on the part of host-country governments can result in an unequal distribution of benefits or an abuse of market power by transnational corporations by crowding out domestic investment.

FDI is increasingly intended to serve global and regional markets, often in the context of international production networks, and the spread of such networks offers, in principle, new possibilities for developing countries and economies in transition to benefit from

FDI in the manufacturing sector. In Africa and Latin America and the Caribbean, FDI is still heavily concentrated in the extraction and exploitation of natural resources, with weak linkages to the domestic economy. Host-country regulations can influence the creation of linkages between domestic producers and foreign affiliates, and also induce FDI to contribute to technology transfer.

An evolving external environment

In sum, there have been improvements over the past decade in several elements shaping the external environment for development, partly as a result of a strengthened global partnership for development. However, not all initial promises or expectations have been fulfilled, and in some areas new challenges have emerged. The various factors that have shaped the external environment for development since the mid-1980s can contribute to faster growth and poverty alleviation by providing new opportunities for trade and sectoral development, or by alleviating financial constraints. Nevertheless, there remains considerable scope for rendering the global trading and financial environment more development friendly. Equally important is the need to strengthen the different elements of global economic governance and achieve greater coherence among these elements. The challenge for developing countries is to translate positive external developments into faster growth of domestic value added, employment and income. Meeting this challenge will require more than a mere reliance on market forces and strengthened social policies. In order to obtain long-term benefits for growth and poverty alleviation from existing and possible future improvements in the external environment developing countries should be able to develop additional support policies for domestic investment, productivity growth and technological change.

Towards a fundamental reorientation of policy

In order to reach the MDGs, developing countries will have to grow much faster than they have done over the past 25 years. But to meet the challenges facing open developing economies, the scope for policy-making will have to be widened beyond what has been acceptable under the standard reform agenda. More proactive policies in support of capital accumulation and productivity enhancement are needed for successful participation in international economic relations, and for sustained improvements in the welfare of all groups of the population. In the past, the potential impact of efficiency gains on growth has frequently been overestimated. The unsatisfactory outcomes of the market-oriented reforms pursued in a majority of developing countries since the early 1980s may largely be due to the reduced number of policy instruments available to policymakers under the development paradigm of the past 25 years.

As a result of integration into global production and financial markets, external influences over national policy targets have become stronger, and the trade-offs between internal and external objectives have intensified. The reduction in policy autonomy is often viewed in connection with commitments undertaken by countries in multilateral agreements, especially in the area of trade. But bilateral or regional trade agreements often involve even tighter constraints, and there are also many other channels outside the trade area through which policy autonomy can be constrained, with consequences that can be even more serious. One prominent example is the conditionalities attached to credit extended by international financial institutions. The proliferation of these conditionalities over the past 20 years has given rise to increasing criticism, especially as they have extended into structural and even non-economic areas

without taking sufficient account of country-specific factors in their formulation.

But apart from such *de jure* constraints of national policy autonomy that are the result of commitments to obligations and acceptance of rules set by international economic governance systems and institutions, there are also a number of important constraints that result *de facto* from policy decisions relating to the form and degree of a country's integration into the international economy. Most notable among these is the loss of the ability to use the exchange rate as an effective instrument for external adjustment, or the interest rate as an instrument for influencing domestic demand and credit conditions, because of a reliance on private capital inflows to finance trade deficits following the opening up of the capital account.

The need for policy innovation

Even in a rather closed economy, formal command over policy instruments does not automatically translate into full control over national targets. It is therefore necessary to analyse the range and kind of policy instruments that individual developing countries have at their disposal to remedy the widespread weaknesses in private capital formation, productivity growth and technological upgrading, as well as the structural and institutional conditions under which these instruments can be effectively used. Moreover, in a highly interdependent and integrated world economy, policies at the national level need to be complemented by some policies operating and controlled at the international level. Indeed, the economic interdependence of countries provides the principal rationale for multilateral disciplines because it gives rise to externalities, spillovers and arbitrage opportunities.

With the liberalization of international trade, external demand conditions have become increasingly important determinants of national investment decisions: the smaller the domestic market and the greater the degree of openness of an economy, the greater is the need to rely on external demand for growth and employment creation. Therefore, policies pursued in other countries, and competition with producers in those countries, become co-determinants of domestic growth. This implies that appropriate multilateral rules and regulations in trade and finance can be of considerable benefit for launching and sustaining a dynamic growth process in developing countries.

On the other hand, widening the scope of national policy instruments beyond those that were deemed acceptable under the development paradigm of the past 25 years would not only allow the pursuit of additional goals, they would also increase the number of potential combinations of instruments, which in many cases will be decisive for the success or failure of a strategy. At the national level, additional policy instruments may need to be explored to ensure price stability and to support domestic producers in their efforts to achieve international competitiveness and maintain it in a dynamic process. As the options for such national instruments are circumscribed by international policies, the latter should be designed in a way that allows greater scope and flexibility for the application of domestic instruments to address the most serious obstacles to growth and development, which differ considerably across countries.

Strengthening the creative forces of markets

As a consequence of the failure of past economic policies that relied primarily on market forces, many developing countries have begun to reconsider the use of proactive trade and industrial policies in their development strategies, despite much controversy concerning their justification and the feasibility of adopting them. Some authors have questioned the efficacy of such policies, tending to associate them with failed inward-looking, import-substituting strategies with open-ended government interventions and a strong bias towards protectionism. The rationale for proactive trade and industrial policies has occasionally been questioned also because of their possible adverse effects on efficient resource allocation and because they could lead to protracted rent-seeking. But recent development research has produced evidence that an exclusive concentration on allocative efficiency implies a lack of sufficient attention to stimulating the dynamic forces of markets which underlie structural change and economic growth, and that industrial policies were an important supportive factor for East Asia's economic catch-up as well as for industrialization in today's mature economies.

Proactive trade and industrial policies should not be understood to mean inward-looking, protectionist defence mechanisms to support industries where production and employment are threatened by foreign competitors that have successfully upgraded their production. Rather, the role of national support policies should be to strengthen the creative forces of markets and related capital formation. The policies should help solve information and coordination problems arising in the process of capital formation and productivity enhancement. They should also ensure that cumulative production experience is translated into productivity gains. This

industrial policy support should be complemented by a trade policy designed to achieve international competitiveness in increasingly more sophisticated products. But recognizing the potential benefits of trade for growth does not mean that across-the-board opening up to international markets is necessary. Rather, acquiring the ability to competitively produce goods that were previously imported is inherent in economic transformation and goes hand in hand with export development. Implementing some temporary protection does not imply adopting an "anti-trade" strategy, rather it should be considered a key element of a policy aimed at "strategic trade integration".

Flexible support policies

Which production should receive industrial and trade policy support and for how long will depend on many factors, which are likely to change in the course of economic development. Policy support for a specific product category may be introduced once the technological barriers to entry are no longer out of reach for domestic manufacturers. But it should be withdrawn when domestic manufacturers attain technological mastery, when domestic production becomes unprofitable at an internationally competitive level, or when benefits from economies of scale and learning by doing get exhausted. With such an approach, any specific product category is a candidate for public support policies only for a limited period of time. The aim is not to pick winners, but to identify and discipline under-performing firms.

Maintaining dynamic scale economies requires both successive innovative investments and learning processes. Temporary subsidies facilitate such investments, while temporary protection allows learning processes to unfold. However, as the potential for learning in a specific activity diminishes with growing experience,

learning and innovative investment depend on each other: new, innovative investments open new possibilities for further learning, which in turn provides the basis for the productive use of a new round of innovative investments, and so on.

Any prescription for development policy must recognize the large differences among countries and respect their unique characteristics. Nevertheless, there are some common features that permit consideration of some general policy principles, which need to be translated into individualized, country-specific policies. Such general principles include policies supportive of innovative investment and of adapting imported technologies to local conditions. Support for domestic as well as foreign investment should be combined with an appropriate regulatory and fiscal framework to secure optimal gains for development. In this context, there is need for a pragmatic and strategic perspective to integrate FDI into a broader development strategy geared to structural and technological change. There is a greater likelihood of industrial policy measures succeeding if they are complemented by trade policies designed to achieve international competitiveness in increasingly sophisticated products. Policy support should be provided only on the basis of clearly established operational goals, observable criteria for monitoring them and within a specified time horizon.

Restrictions imposed by international trade agreements

There are widespread concerns that the international trade rules and regulations, which are emerging from multilateral trade negotiations and a rising number of regional and bilateral trade arrangements, could rule out the use of the very policy measures that were instrumental in the development of today's mature economies and

late industrializers. This would imply a considerable reduction in the flexibility of national governments to pursue their development objectives. Another concern is that these rules and commitments, which in *legal* terms are equally binding for all countries, in *economic* terms might impose more binding constraints on developing than on developed countries, because of the differences in their respective structural features and levels of industrial development.

The imposition of performance requirements on foreign investors is a key regulatory measure that has been curtailed by the Agreement on Trade-Related Investment Measures (TRIMs). While developed countries extensively employed such requirements at earlier stages of their industrial development, developing countries have only recently started to use these policy tools to foster their industrialization and technological upgrading. In efforts to participate in international production networks, for example, domestic content requirements have been introduced with a view to increasing technology transfer and the use of domestically produced inputs. Empirical evidence suggests that such measures can help meet these objectives. However, developed countries have brought a number of cases against developing countries before the World Trade Organization (WTO) dispute settlement mechanism, especially in the automotive sector, invoking the rules and commitments of the TRIMs Agreement.

The Agreement on Subsidies and Countervailing Measures (SCM) applies to specific subsidies, and thus affects the selective function of policy. It is asymmetrical insofar as subsidies impose a cost on public budgets, which developed countries can afford more easily than developing countries. It prohibits making subsidies conditional on export performance. Yet this has been an important instrument in the reciprocal control mechanisms applied in some East Asian countries, which have often been identified as key to the greater success of industrial policy in that region compared to Latin America.

Many observers consider the Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS) to be the most controversial of the Uruguay Round Agreements (URAs) because of its potential to restrict access of developing countries to technology, knowledge and medicines. The limitations introduced by TRIPS imply an asymmetry that favours the owners of protected intellectual property – mainly in developed countries – at the expense of those trying to gain access to such intellectual content, mainly in developing countries. Moreover, the provisions in the Agreement are specific, binding and actionable with regard to the protection of intellectual property, and non-compliance can be challenged under the WTO's dispute settlement mechanism. By contrast, provisions regarding technology transfer and technical cooperation, which are of importance mainly for developing countries, are of a "best endeavour" nature and difficult to enforce, and non-compliance is not subject to a penalty. The TRIPS Agreement has, nonetheless, left room for variation across countries. For example, developing countries can impose stringent rules on patent disclosure and subsequently grant narrow patents, or they can have flexible discretionary use of compulsory licensing. However, in many cases regional and bilateral trade agreements foreclose part of the autonomy left open to developing countries by TRIPS.

Industrial tariffs in support of diversification

The use of industrial tariffs is in many respects not the best tool to promote diversification and technological upgrading. Nonetheless, developing-country policymakers may be hesitant to abandon such tariffs, for three main reasons. First, tariffs remain an important source of fiscal revenue for many developing countries. Second, since the Uruguay Round Agreements reduced the degrees of freedom for developing countries to use other policy

instruments to support diversification and technological upgrading, the relative importance of industrial tariffs has increased. Third, and perhaps most importantly, the economic impact of changes in industrial tariffs is often assessed in terms of welfare gains or losses resulting from the reallocation of existing resources. From this perspective, a trade policy aimed at low and uniform tariffs across industrial sectors with full binding coverage will maximize a country's welfare benefits. But such an assessment pays little attention to the implications of tariff cuts and harmonization for capital accumulation, technological change and productivity growth, which underlie industrialization and economic development. To this end, it is important for developing countries to be able to modulate applied industrial tariffs levied on particular product categories in accordance with their path of technological upgrading as a key instrument of sectoral policy. To be sure, this kind of tariff policy does not imply either the imposition of high applied tariffs for all sectors at any one time or the imposition of high average applied tariffs. On the contrary, it is likely to result in lower average applied tariffs than would be the case if tariff policy were looked at from a tariff line-by-tariff line perspective.

This kind of flexible tariff policy would be best accommodated by a strategy of maintaining bound tariffs at a relatively higher level (or maintaining a large part of industrial tariffs unbound) and modulating applied tariffs on particular industrial sectors around a relatively lower average level. This would be possible if industrial tariff reduction obligations from international agreements extended only to average tariffs, and not to individual tariff lines as has been the case in all multilateral trade agreements concluded so far. A number of developing countries have maintained a tariff regime that allows them to modulate applied tariffs on manufactured goods. However, the current multilateral negotiations on non-agricultural market access are set to reduce this flexibility in tariff setting and binding that developing countries have so far been able to maintain.

The scope for proactive trade and industrial policies

Thus an assessment of the extent to which various international trade arrangements have restricted the degrees of freedom of developing countries to pursue proactive trade and industrial policies gives a mixed picture. On the one hand, WTO rules and commitments have made it far more difficult for developing countries to combine outward orientation with the kind of policy instruments that today's mature and late industrializers employed to promote economic diversification and technological upgrading. On the other hand, under the current set-up of multilateral trade rules, countries still have the possibility to pursue policies that will help them generate new productive capacity and new areas of comparative advantage. Such policies largely concern the provision of public funds in support of R&D and innovation activities. Countries in a position to use the WTO rules and commitments to this effect can continue to support their own industries, target national champions, and generally promote national efforts towards technological advancement.

Therefore there remain considerable degrees of freedom for national policy-making that have not been circumscribed by the URAs. However, the asymmetries in the URAs should not be underestimated. They result from the fact that while the negotiated agreements apply to all WTO members equally in terms of *legal* obligations, they are much more burdensome for developing countries in *economic* terms. It is therefore crucially important to look at the "level playing field" metaphor not only in terms of *legal* constraints, but also, and more importantly, in terms of *economic* constraints, considering countries' different structural features and levels of industrial development. Moreover, what is left of the de-

grees of freedom for developing-country policymakers after the URAs has been further reduced by a number of regional and bilateral free trade agreements with developed countries.

The Doha Work Programme has yet to deliver on the development promises of the Doha Declaration. The eventual outcome may well further reduce flexibility in policy-making by developing countries, particularly in the area of industrial tariffs. On the other hand, lack of progress in the multilateral negotiations may result in greater importance being given to regional or bilateral free trade arrangements as the legal mechanisms that define rules and disciplines in international trade. While these arrangements may improve developing countries' access to developed-country markets, they may entail further reduction in the degree of freedom in national policy-making than that emerging from a Doha Round Agreement. This could make it even more difficult for developing countries to create the supply capacity needed to take advantage of improved export opportunities.

Financial markets and the choice of the exchange-rate regime

The ongoing process of globalization has also changed the framework of national macroeconomic policy. For many developing countries and economies in transition, opening their borders to international trade and private capital flows has been associated with crises that were triggered by instability and turmoil in the international financial markets.

Deregulation of domestic financial markets, including the elimination of credit controls, deregulation of interest rates and the privatization of banks, was a key element in the reform agenda of

the 1980s and 1990s. It was based on the belief that lifting "financial repression" and freeing prices on the capital and money markets would improve intertemporal resource allocation, enhance willingness to save and attract additional resources to the banking system. Combining this with a liberalized capital account, developing countries would attract financial savings originating in more prosperous and capital rich economies, and thus overcome a major barrier to growth.

At the same time, however, there was no clear concept of how the most important international price, the exchange rate, and, closely related to it, the interest rate, should be determined or regulated. The two options for national exchange-rate policy that eventually came to be considered viable were either to let the currency float freely or to adopt a completely fixed exchange rate ("hard peg"), options that came to be known as the "corner solutions".

For small open economies, and developing countries in particular, the exchange rate is the most important single price, as it has a strong impact on the domestic price level and on overall competitiveness. It must be flexible enough to prevent persistent misalignments that would harm the competitiveness of domestic producers and their trade performance. At the same time, excessive volatility of the exchange rate must be avoided, as this would heighten the risks for long-term investment, increase domestic inflation and encourage financial speculation.

The "corner solutions" are based on the assumptions that, in the case of free floating, international financial markets smoothly adjust exchange rates to their "equilibrium" level, while in the case of a hard peg, product, financial and labour markets would always smoothly and rapidly adjust to a new equilibrium at the predetermined exchange rate. In reality, however, exchange rates under a floating regime have proved to be highly unstable, leading to long spells of misalignment, with dire consequences for the real economic activity of the economies involved. The experience with hard

pegs has not been satisfactory either: as the exchange rate could not be corrected in cases of external shocks or misalignment, adjustments were costly in terms of lost output, and the real sectors of the domestic economy bore the brunt.

Given this experience with both rigidly fixed and freely floating exchange rates, "intermediate" regimes have become the preferred option in most developing countries with open capital markets; they provide more room for manoeuvre when there is instability in international financial markets and enable adjustment of the real exchange rate to a level more in line with a country's development strategy. None of the "corner solutions" offer these possibilities. Combining a *completely* open capital account with *full* autonomy in monetary policy and *absolute* exchange-rate stability is impossible, but engaging in a *managed-floating* exchange-rate regime, combined with *selective* capital controls, (i.e. reclaiming *some* monetary policy autonomy) seems to be a viable second-best solution.

Towards a more effective assignment of macroeconomic policies

The perception that price stability is the most important condition for satisfactory growth performance has dominated the assignment of macroeconomic policy instruments in both developed and developing countries in the last two decades. The orthodox approach for "sound macroeconomic policies" has assigned to monetary policy the role of a guardrail for any combination of fiscal and structural policies, and against any kind of shock, regardless of whether it originated on the supply or the demand side. The role of fiscal policy in this assignment has been limited to assisting monetary policy in keeping budget deficits low.

Price stabilization has also been a key target in the most successful cases of economic catch-up, but here the assignment of policies to reach this target has been different. In the Asian newly industrializing economies (NIEs), stabilization was achieved mainly through heterodox, non-monetary instruments, such as an incomes policy or direct intervention in the goods and labour markets. At the same time, monetary and fiscal policies adopted instruments to achieve fast growth and high investment: low interest rates and, at least since the Asian financial crisis, a slightly undervalued exchange rate, combined with fiscal stimulus whenever that was required in light of cyclical developments.

The point of departure of such policies is the perception that in a world where higher planned savings do not automatically generate higher fixed investment, economic policy has to focus on the creation of savings through investment and the resulting income growth. This approach requires a monetary policy that will provide financing possibilities to enterprises that do not yet exist. Such a policy is potentially inflationary, but it does not lead to inflation if real investment and growth absorb the excess liquidity that is created. There is thus a narrow link between the process of catching up and structural change, on the one hand, and the development of a country's monetary system and stabilization instruments, on the other.

External financing remains necessary to the extent that greater imports of capital goods as a result of higher investment lead to a current-account deficit. But many successful cases of economic catch-up, and most recently China, have shown that such deficits do not necessarily occur, and that domestic financing of investment can substantially lift growth rates without net foreign savings. The decisive factor for catching up is domestic accumulation of capital in a process of rising real incomes for all groups of society.

In any case, price stabilization is crucial for sustaining a dynamic growth process: in countries that are prone to high inflation

it is much more difficult to start and sustain a process of development and catching up because of the frequent need to tighten the creation of money and credit. Without a sufficient number of policy instruments that can be used effectively to dampen inflationary risks, the attempt to boost development through expansionary macroeconomic policies is likely to fail, as inflation will rapidly flare up. Conversely, countries that successfully use heterodox instruments to achieve price stability have more room to employ macroeconomic policy to spur an investment-led development process.

Exchange rates, interest rates and capital inflows

In the absence of effective multilateral arrangements for exchange-rate management, macroeconomic policy in many developing countries has aimed increasingly at avoiding currency overvaluation. This has not only been a means to maintaining or improving international competitiveness, it has also been a necessary condition for keeping domestic interest rates low and an insurance against the risk of future financial crises.

Independence from international capital markets allows central banks to use the instruments at their disposal for actively pursuing development targets, provided that an acceleration of inflation is kept in check by non-monetary measures, such as an incomes policy, institution-building in support of creating a national consensus on reasonable wage claims, or direct government intervention in determining prices and, even more importantly, nominal wages. Examples of this approach are the policy mix in some Asian NIEs, and in China following its financial crisis in 1994, and, more recently, the experimentation with new price stabilization devices in Argentina. Many other developing countries that lacked

the additional policy instruments to stabilize inflation had to choose between a policy of low interest rates that favour domestic investment and discourage capital inflows, but fuel inflation, and one of relatively high interest rates that keep inflation low, but discourage domestic investment and attract capital inflows, which required intervention and, often costly, sterilization.

The heterodox Asian policy mix has been complemented by various forms of capital-account regulation. While such regulation may help to contain, and to some extent also prevent, crises, the prime objective of economic policy should be to prevent the emergence of large interest rate differentials, arbitrage possibilities and incentives for speculation. However, as speculation on currency appreciation and the concomitant destabilizing inflows of hot money cannot completely be avoided, a pragmatic approach to managing such flows has proved helpful.

National institutions and governance arrangements

There is an increasing consensus among economists and policymakers that national institutions matter as a critical determinant of growth. There is much less agreement as to what exactly the role of institutions should be in the pursuit of development objectives, and what types of institutional arrangements are the most appropriate to achieve these objectives.

Conventional wisdom suggests that the main role of institutions should be to reduce transaction costs so as to create new markets and make existing markets function more efficiently. Economic policies should be supported by universally applicable types of institutions, particularly for granting and protecting property

rights, in line with "global best practices", derived from the current institutional set-up in developed countries. Proponents of this approach point to empirical evidence from cross-country analyses, which typically find a positive correlation between the quality of institutions and the level of income. However, this does not imply that an improvement in market-enhancing institutional conditions (such as the protection of property rights, the rule of law and anti-corruption policies) is a precondition for growth and convergence with advanced countries. Rather, good institutions and good economic performance are interrelated.

A closer analysis of the relationship between institutional quality and income convergence of developing countries with developed countries reveals that diverging and converging developing economies alike score relatively low in terms of institutional quality. This suggests that large-scale institutional reform is seldom necessary at the initial stages to accelerate growth. It is only after developing countries have achieved sustained economic convergence that it may be necessary to create institutions similar to those existing in today's developed countries.

Institutions in support of proactive trade and industrial policies

An emphasis on industrialization and structural change leads to an additional role for institutions, which is to provide mechanisms for the effective implementation of policies designed to achieve high rates of investment and encourage the adoption of new technologies. Thus the guiding principle of institutional change should be to address the information and coordination problems that undermine entrepreneurial decision-making and improve checks and balances on the use of government discretion. While such insti-

tutional arrangements have to fulfil largely similar functions in different countries, their form may vary considerably from country to country, as well as within the same country over time.

A large number of developing countries pursued proactive trade and industrial policies until the beginning of the 1980s. However, at the time, it was not well recognized that the successful implementation of such strategies required a complementary set of institutional and administrative capabilities. It was only after the successful experiences of the late industrializers, particularly in East Asia, had been properly assessed that the importance of supportive institutional arrangements for making domestic policy instruments more effective came to be more widely acknowledged.

For initiating and supporting a process of sustained growth and structural change, it is particularly important to create institutional arrangements that manage economic rents associated with proactive trade and industrial policies. Once an economy is on a path of sustained catch-up growth, the government's capacity to support the creation of high-quality institutions through increasing public expenditure will also increase. These two processes are closely interrelated and create a virtuous circle of improved economic performance, enhanced institutional transformation and more effective public policies.

Linking support to performance requirements ensures that the initial rents are part of a nurturing exercise, and that they will eventually be withdrawn as the supported activity matures. In a sense, the enforcement of such performance requirements represents the "stick" that is a necessary complement to the "carrot" provided by the creation of temporary rents from subsidies or protection. The relationship between the State bureaucracy and the private sector should be one of "embedded autonomy". The effectiveness of proactive trade and industrial policies for achieving their objectives depends on the professionalism of the bureaucracy and the

efficiency of information exchange between the public and private sectors. It also depends on the extent of the authority wielded by public policy-making entities and on their access to budgetary resources that can be directed to those goals, including through the creation and withdrawal of rents. Yet it should not be presumed that the institutional arrangements required to implement more orthodox policies (such as rapid liberalization and privatization) are less demanding than those needed to accompany proactive support policies.

Multilateral institutions and global governance

The considerable and still growing degree of global interdependence in contemporary world economic relations provides a strong rationale for a well-structured system of global economic governance. Self-centred national economic policies, if left unchecked, can generate adverse international spillover effects. Moreover, global economic interdependence provides an opportunity for policymakers in influential economies to deliberately adopt beggar-thy-neighbour types of policies. They may be tempted to employ commercial, macroeconomic, financial or exchange-rate policies in pursuit of certain national economic objectives – such as attaining mercantilist goals or postponing the adjustment of internal or external imbalances – which may harm the economic performance of other countries. In the absence of multilateral disciplines and cooperation, retaliatory action by adversely affected countries could lead to instability and disruptions in international economic relations that might leave all countries worse off.

But for such global collective action to be acceptable to all parties, it must result from a consultative process based on full,

equal and voluntary participation of all the parties concerned. Any perception that multilateral disciplines extend too far and constrain the attainment of legitimate national development goals greatly depends on an individual economy's structural characteristics and its level of development. There is no single quantifiable balance between multilateral disciplines and national policy autonomy that would suit all countries or apply across all spheres of economic activity.

The multilateral trade regime overseen by the World Trade Organization contributes to certainty and predictability in international trade, as it provides a framework for an orderly, rules-based system of international trade, with appropriate checks and balances, arbitration of inter-State disputes and determination of the sanctions to be applied. This regime has been under increasing pressure to expand the number of areas regulated by multilateral disciplines and to move towards the establishment of a homogeneous regulatory framework. However, such changes are unlikely to take adequate account of the asymmetries existing between the different actors in the world economy. In order to avoid a deadlock in multilateral negotiations, which would have adverse effects on the substantial gains that multilateral disciplines in the area of international trade have achieved so far, the multilateral trade regime must be fully inclusive, and have a sufficient degree of flexibility to reflect the interests and needs of all its members.

How can the multilateral trade regime move forward?

Further discussions and negotiations will need to explore a range of options aimed at creating a new framework or new guidelines for special and differential treatment (SDT) in the WTO. This endeavour would probably need to start from the recognition that SDT for developing countries means redressing structural imbalances rather than giving concessions. From this perspective, and in the spirit of the global partnership for development, developed countries would need to agree to a new framework or new guidelines for SDT without receiving concessions in return.

Differences among countries in their structural characteristics or approaches to economic policy can be reflected in two ways. The first is to adopt a country-specific approach that would allow member countries to selectively opt out of certain rules and commitments, depending on their specific national priorities. This would provide flexibility to enable developing countries to seek some latitude in the application of multilateral disciplines consistent with the pursuit of national development goals. Its main drawback is that it would result in a multi-track trade regime, thus conflicting with the basic rule of non-discrimination and complicating adherence to the consensus-based norm of the existing regime. Moreover, it runs the risk of leading to a proliferation of specific agreements, with disciplines that may well go beyond the scope desired by developing countries for many years to come. Thus countries that opt out will not enjoy the benefits of existing multilateral disciplines, and might not be able to renegotiate them once they decide to sign on to a specific agreement.

The second option is to adopt an agreement-specific approach that would set specific criteria for individual agreements, which would form the basis for determining whether members could opt out of the application of negotiated disciplines for a limited period of time. As with the first option, following this second option would lead to differentiation between developing countries, but in this case differentiation would be based on objective criteria. The criteria used and the specific levels chosen would need to be the outcome of negotiations that strike a balance between a country's needs and the potential damage inflicted on other members by relaxing an agreed rule.

The options suggested here are intended simply to sketch out some possible ways forward. Multilateral discussions and negotiations may well lead to other solutions, but no matter which option is chosen, it should take account of the wide disparity in structural characteristics and approaches to economic policy among the many members of the WTO, and the consequent need for greater flexibility.

Asymmetries in global economic governance

An appropriate balance between national policy space and international disciplines and commitments requires not only strengthening the development dimension in the multilateral trading system but also an improvement in the global governance of international monetary and financial relations. At present, this balance is not warranted largely because of two asymmetries. First, contrary to the existing institutional structure in international trade, current international monetary and financial arrangements are not organized around a multilateral rules-based system that applies a specific set of core principles to all participants. This asymmetry has particularly strong adverse impacts on developing countries,

because self-centred national monetary and financial policies can have much more damaging effects than those caused by trade and trade-related policies. Second, the multilateral rules and commitments governing international economic relations are, in legal terms, equally binding on all participants, but in economic terms they are biased towards an accommodation of the requirements of the developed countries.

Taken together, these two asymmetries result in international rules and practices that seek to deepen economic integration in a number of areas crucial to the interests and priorities of developed countries, and reduce the degrees of freedom for national economic policies in areas crucial for industrialization and economic catch-up in developing countries. Thus, in qualitative terms, and from the perspective of development, the scope of multilateral disciplines in the current pattern of global economic governance appears to be too narrow in the area of international monetary and financial relations, but may well be too broad in the area of international trade.

This is so because the rapid pace of globalization in monetary and financial relationships has not been accompanied by an equally rapid change in multilateral monetary and financial rules and disciplines. Above all, the existing system lacks institutional arrangements for the enforcement of multilateral discipline on exchange rates. Until the early 1970s, the Bretton Woods system obliged central banks to intervene in foreign-exchange markets in order to maintain exchange-rate stability within a narrow band and restrict short-term arbitrage flows which had proven so damaging in the inter-war period. By defining narrow exchange-rate bands, the Bretton Woods system limited the ability of governments to manipulate the exchange rates of their currencies. These institutional arrangements allowed the system to maintain a balance between national policy autonomy on the one hand and multilateral disciplines on the other. Sacrificing formal monetary autonomy was rewarded by stability in the financial markets and better foresight

in international trade and in related decisions concerning investment in fixed capital.

The IMF Articles of Agreement provided for changes in par values in cases of fundamental disequilibria in foreign trade in order to allow the member countries to prevent or correct balance-of-payments disequilibria without having to resort to measures "destructive of national or international prosperity" (Article 1). In many cases such measures were supported by appropriate financing of foreign obligations to soften adjustment pressures. However, following the termination of the Bretton Woods exchange-rate system, the balance between financing and adjustment in crisis situations was gradually lost. The provision of liquidity to allow countries to weather payments difficulties was often inadequate, while the IMF started to impose extensive adjustment requirements in macroeconomic and even in structural policies.

Today, the IMF may intervene in a country's exchange-rate policy only if that country asks for financial support from the Fund and thus becomes subject to IMF conditionality. By contrast, negotiations on exchange rates among the most important currencies, when they occur, are held outside the IMF, mainly in the G-7 meetings or in bilateral talks among the major industrialized countries. Indeed, the institution that is in charge of promoting exchange-rate stability and preventing excessive and prolonged payments disequilibrium is unable to impose meaningful disciplines over the policies of those countries that run the most significant external imbalances and whose exchange-rate volatility has the greatest – negative – impact on the international economy. The Fund's policy oversight is confined primarily to its poorest members who need to draw on its resources because of their lack of access to private sources of finance and, occasionally, to emerging-market economies that experience disruptions in financial markets and financial crises. As a result, the bulk of adjustment in case of external imbalances is concentrated on a group of developing and transition economies, despite

the fact that the source of such imbalances may oc ur in the developed world.

The lack of a functioning financial framewor in a globalized economy requires a new and multilateral approac to the management of the most important international price th exchange rate. A new or reformed institution that promotes a sy m of stable exchange rates to ensure a predictable trading enviror nent would need to provide more symmetrical treatment to all m mber countries. The main objective of such an institution would the prevention of systemic financial crises based on a close mo itoring of trade imbalances and global exchange-rate misalignm nts in both surplus and deficit countries. Separating surveillar e from lending decisions and assigning it to an independent au ority could improve its quality, legitimacy and impact.

S. Panitchpakdi

Supachai Panitchpa di
Secretary-General of U TAD

Printed at United Nations, Geneva
GE.06-51252 August 2006 4,180
UNCTAD/TDR/2006 (Overview)